KROES ENERGY INC.

2001 ANNUAL REPORT

Corporate Profile

Kroes Energy Inc. is a junior oil and gas exploration and production company headquartered in Calgary, Alberta, Canada and listed on the TSX Venture Exchange. It is the objective of the Company to participate in oil and gas ventures both in Canada and outside of Canada.

The Company presently has interests in crude oil and associated natural gas production in western Saskatchewan; and a working interest in a 1,959-acre block on the Cedros Peninsula of southern Trinidad that produces a small volume of oil.

On January 09, 2002 the Company conditionally closed the acquisition of Zhoda 2001 Corporation, a private Alberta company that holds a 45% joint venture interest in a Ukrainian oil field rehabilitation project.

DIRECTORS

Stephan V. Benediktson
San Miguel de Allende, Mexico

Fred Callaway
Calgary, Alberta

David E. Powell
Calgary, Alberta

Edward M. Southern
Calgary, Alberta

Dr. James Werbicki
Saskatoon, Saskatchewan

Darrell M. Zakreski
Calgary, Alberta

OFFICERS

Fred Callaway
President

Edward M. Southern
Executive Vice President

Richard A. Wilson
Secretary

Annual Meeting

The Annual General Meeting of the Shareholders will be held in Calgary on Monday, June 25, 2002 at 3:00 p.m. in the McDougall room of The 400 Club, location at 710 – 4th Avenue S.W.

KROES ENERGY INC.

2001 ANNUAL REPORT

To the Shareholders

The price of crude oil weakened through 2001 and at year-end was at a low for the year. This impacted the financial results of Kroes Energy Inc., but the effort expended during the year to close the acquisition of Zhoda 2001 Corporation and the excellent results from its 45% interest in the Ukrainian oilfield rehabilitation project provides encouragement that the future is bright for the Company.

Financial and Operating Results

Production revenue for 2001 totalled $734,193, a decline of 16% from the prior year due to a 14% drop in average crude oil price and modestly lower production volumes. As a result, funds from operations declined to $158,404 from $274,485 recorded in 2000. The Company recorded earnings of $124,759 but the write-off of its $602,680 investment in Cuba resulted in a net loss of $477,921. Production for the year averaged 50 barrels of oil equivalent per day, down from 54 barrels per day in 2000 because of lower production from Trinidad.

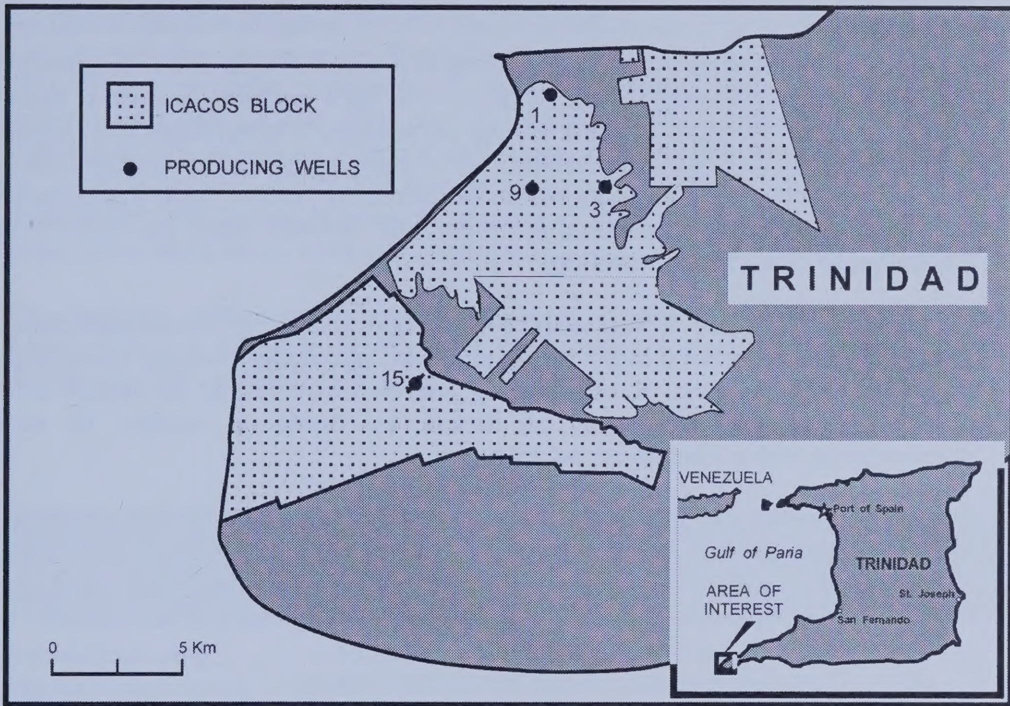
Additional details on the financial and operating results is presented in the Management Discussion and Analysis beginning on Page 7.

Activities – Canada

Production from the Company's Saskatchewan properties averaged 42 barrels of crude oil per day, unchanged from 2000. Associated natural gas production averaged 45 thousand cubic feet per day, essentially the same as the prior year.

Activities - Trinidad

On the Icacos Block in Trinidad, where Kroes holds a 25% working interest, production from the three producing wells was shut in for a number of months to construct a new water disposal system. Approval to resume production was received from the Environmental Authority in October at which time production returned to the previous level of 30 to 35 barrels per day, of which Kroes' share is about 8 barrels per day. The average for the year however was only 4 barrels per day.



During the year an extensive test was carried out on the Icacos #15 light oil discovery made in 1999 on the southern portion of the block. The test was inconclusive, as the producing sand had been extensively damaged by drilling mud during the drilling of the well and with the low pressures in the formation it was not possible to clean up the well sufficiently to produce economic quantities. In an effort to define the extent of this shallow oil pool, in 2002 a number of stratigraphic test holes will be drilled to a depth of about 800 feet. It is the belief of the partners that these wells should produce about 10 barrels per day and if the sands are sufficiently extensive and productive, approval from the Ministry will be sought to enlarge the test holes and implement a production operation.

Activities - Cuba

Kroes acquired a 7.5% working interest in Blocks, V, VI & VII offshore Cuba in 1997 at a cost of $602,680 and following the first well that was drilled in 1997, converted its interest to a 4.875% carried interest. The Ana Maria #1 well was a dry hole, as were two follow-up wells drilled in 1998. The drilling of another well was delayed while the Technical Committee of partners carried out considerable work to reduce the risk of more dry holes. This activity was inconclusive and late in 2001 the decision was reached to relinquish the blocks due to the lack of prospectivity related to an apparent absence of hydrocarbon source in the basin. As a consequence, the $602,680 book value was written off in 2001.

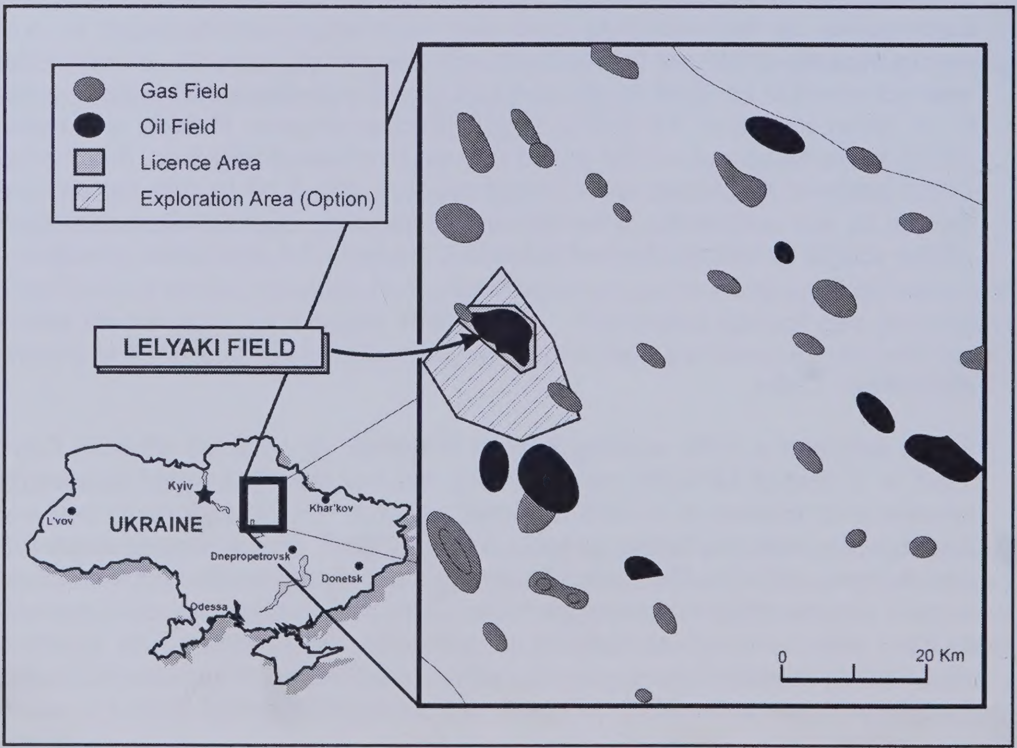
Activities - Ukraine

In 2000 Kroes entered into an agreement to acquire Zhoda 2001 Corporation, a Canadian private company that holds a 45% joint venture interest in Kashtan Petroleum Ltd. Kashtan holds a license agreement to rehabilitate the Lelyaki oil field located in east central Ukraine. At a meeting of Kroes' shareholders on October 25, 2000 the Directors were authorized to proceed with the acquisition and in January 2002 conditional approval was received from the TSX Venture Exchange to close the transaction.

On January 09, 2002 Kroes issued 8,600,000 shares to the shareholders of Zhoda at a deemed price of $0.12 per share for aggregate deemed consideration of $1,032,000, bringing its outstanding shares to a total of 20,349,341. The completion of the acquisition of Zhoda by Kroes is subject to certain requirements of the Exchange, as follows:

(i) Submission of unqualified audited financial statements for Kashtan and Zhoda at December 31, 2001;
(ii) Additional verification that Kashtan's License Agreement is in good standing and that it will not be impaired by the acquisition of Zhoda by Kroes.
(iii) Completion of a financing for CAD$1 million;
(iv) Completion of a Filing Statement; and
(v) Completion of an Exchange Escrow Agreement.

The Company expects these conditions to be satisfied by June 30, 2002.



As part of the due diligence prior to the acquisition, an Engineering Report on the Lelyaki field was prepared by PetroGlobe (Canada) Ltd. and is dated July 2000. The Report provides estimates of proved, probable and possible crude oil reserves for the Lelyaki field and it identifies those attributable to Kashtan Petroleum Ltd. as well as Zhoda's 45% share. The Engineering Report attributes to Zhoda's interest, 8,572,000 barrels of proved, 5,184,000 barrels of probable and 26,607,000 barrels of possible reserves. Significant capital expenditures are required to bring these reserves on stream.

The following table summarizes the volumes and the values attributed to Zhoda (converted from $USD to $CAD at $1.59) and using a constant oil price of USD $20 less a 10% quality adjustment.

PETROGLOBE REPORT - July 2000

Crude Oil Reserves	Lelyaki Field Barrels	Kashtan Share Barrels	Zhoda 45% Barrels	Zhoda 45% 0% DCF	Zhoda 45% 15% DCF
Proved Producing	1,642,000	1,218,000	548,000		
Proved Undeveloped	17,831,000	17,831,000	8,024,000		
Total Proved	**19,473,000**	**19,049,000**	**8,572,000**	**$62,602,000**	**$18,752,000**
Probable – New Wells	6,928,000	6,928,000	3,118,000		
- Existing Wells	4,592,000	4,592,000	2,066,000		
Total Probable	**11,520,000**	**11,520,000**	**5,184,000**	**$28,221,000**	**$8,057,000**
Proved and Probable	**30,993,000**	**30,569,000**	**13,756,000**	**$90,823,000**	**$26,809,000**
Possible	**59,127,000**	**59,127,000**	**26,607,000**		

The Lelyaki oil field is located in east-central Ukraine and has produced nearly 400 million barrels of oil since its development by Ukranafta, in the late 1960's. The production license covers 67.3 square kilometres and there is an associated optional exploration area of some 327 square kilometres. Production peaked at 95,000 barrels per day in 1975 and very little remedial work has been done since that time. The field now produces approximately 1,000 barrels per day. Kashtan obtained the license to redevelop the Lelyaki field in February of 1995. The license has a term of twenty years and can be renewed for a further 20 years. The license gives Kashtan the right to acquire production by working over wells or drilling new wells and through these operations over the past five years, Kashtan has earned approximately 460 barrels per day of total field production, of which 360 barrels per day was added in 2001 and 2002. Kashtan has a small staff that directs the field activities and the work is carried out by Ukranafta on a contract basis. Zhoda's 45% share of Kashtan's current production is 207 barrels per day.

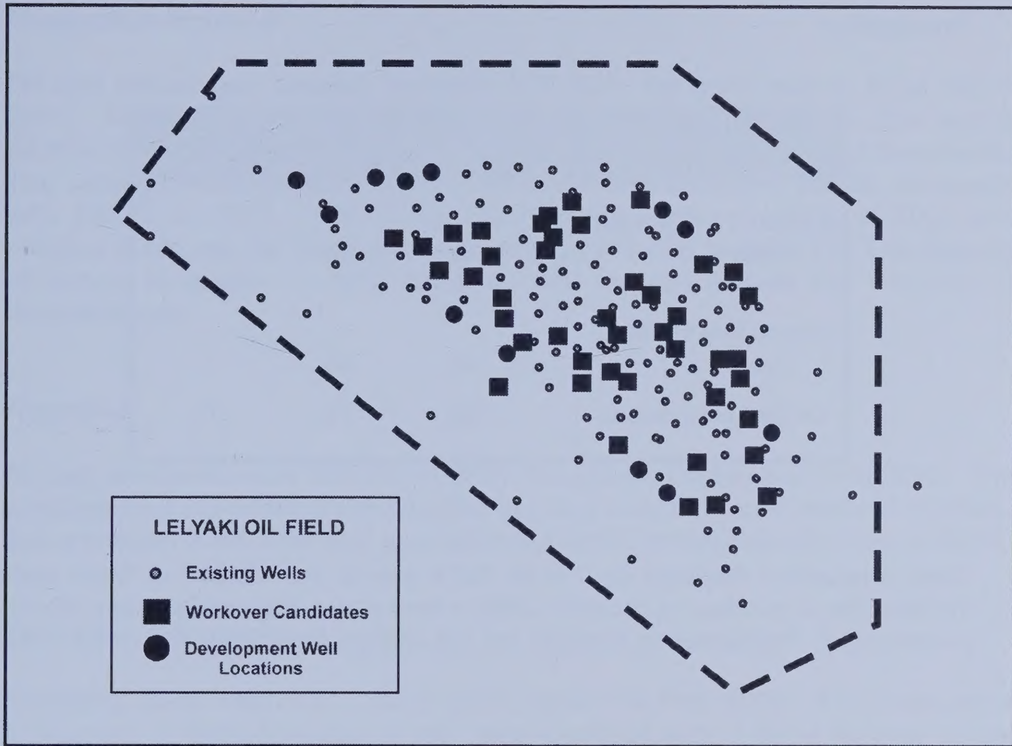
Zhoda received final documentation of its title to the interest in Kashtan from the Ministry of Environmental Protection and Natural Resources of Ukraine on September 26, 2000 when the license agreement was amended to reflect Zhoda's participation. Included in the amendment were work obligations for Kashtan to complete 16 workovers, drill 4 development wells and commence preliminary exploration activity by December 31, 2002. During 2001, 8 workovers and two development wells were completed and approximately 250 barrels per day of production was added. These activities were financed with Kashtan's cash flow and working capital.

The following table provides the audited financial and operating results of Kashtan (converted from $USD to $CAD at $1.59) for the fiscal year 2000 and 2001.

Kashtan Petroleum Ltd.	2001	2000
Revenue	$1,868,000	$1,212,000
Funds generated from operations	$1,081,000	$427,000
Net profit from operations	$335,000	$338,000
Crude oil production - (Bbls per day)		
- Average for the year	182	115
- Average for December	360	108

Kroes has agreed to provide financing to Kashtan in 2002 by providing a Letter of Credit to Credit Lyonnais Bank in Ukraine in the amount of USD$787,500 as 105% backing for a line of credit to be extended to Kashtan. Kashtan will draw down the line of credit as required to supplement its cash flow and pay for the drilling and workover activity on the Lelyaki field. As Kashtan's cash flow increases, it will repay the line of credit and when it is no longer required, Kroes will redeem its Letter of Credit.

The financing provided by Kroes will be supplemented by Kashtan's cash flow in 2002 and the total will be dedicated to the planned work program. This program includes the remaining license obligations of 8 workovers, 2 development wells, seismic evaluation and preliminary expenditures for the drilling of an exploration well.



Plans for 2002

The letter of credit required to finance a portion of Kashtan Petroleum Ltd.'s work plan will require Canadian funds of approximately of $1,250,000. On March 26, 2002 the Company initiated a financing to achieve this requirement and has engaged Roche Securities Ltd. of Edmonton, Alberta as its agent.

The financing is for a maximum of $1,750,000 and a minimum of $1,500,000 and involves the sale of 7,000,000 units and 6,000,000 units, respectively, at 25 cents per unit. Each unit comprises one common share and one common share purchase warrant. The warrant has a term of 18 months and can be exercised to purchase one common share at 50 cents. The financing is expected to be completed by the end of May 2002.

Management's Discussion and Analysis

Management's discussion and analysis should be read in conjunction with the financial statements and notes contained in this annual report and are based on information available as at May 17, 2002. The term "boe" refers to barrels of oil equivalent, with natural gas volumes converted to oil equivalence at a ratio of 10,000 cubic feet per barrel.

Production

Average Daily Production Years ended December 31	2001	2000	% Change
Crude Oil & NGL's (bbl/d)			
Canada	42	42	0
Trinidad	4	8	(50)
Natural Gas (mcf/d)			
Canada	45	44	2
Oil Equivalent (boe/d)	50	54	(7)

Total production declined by 7% in 2001 due to the shut-in of three wells in Trinidad for a number of months while a new water disposal system was being constructed. Production in Canada did not change from 2000.

Selected Financial Information

Years Ended December 31	2001		2000	
	$000	$boe	$000	$boe
Oil and gas revenue	734	40.50	878	44.55
Royalties	(39)	(2.15)	(40)	(2.03)
Field operating costs	(422)	(23.29)	(461)	(23.39)
Net operating income (netback)	**273**	**15.06**	**377**	**19.13**
General and administrative	(123)	(6.79)	(108)	(5.48)
Other items	8	0.44	5	0.25
Funds generated from operations	**158**	**8.71**	**274**	**13.90**
Depletion, depreciation and site restoration costs	(27)	(1.49)	(42)	(2.13)
Write down of assets	(603)	(33.27)	0	0
Provision for income taxes	0	0	(75)	(3.80)
Other non-cash items	(6)	(.33)	(4)	(.20)
Net income (loss)	**(478)**	**(26.58)**	**153**	**7.77**

Production Revenue

Oil and natural gas revenue declined 16% from the prior year to $734,193 in 2001. This decline was due to lower oil prices in the last half of 2001 and a decline in Trinidad oil production because of the temporary shut-in of three wells. The average crude oil price fell 14% in 2001 and averaged $36.85 compared with $42.72 in 2000. Natural gas prices were higher by 20% in 2001 and resulted in natural gas revenues increasing by $18,698 to $97,757. The majority of Kroes' production is light crude oil and is produced in the Province of Saskatchewan.

Royalties

Royalty payments were $39,018 in 2001, essentially unchanged from 2000. The royalties paid represent a combination of gross overriding and freehold royalties, and averaged 5.3% of oil and gas revenue in 2001 compared with 4.5% in 2000.

Operating Expenses

Operating costs were $421,576 in 2001, down 8% from 2000. The Company's production in Saskatchewan is very light crude oil from a large number of low productivity wells, resulting in high unit operating costs. On a barrel of oil equivalent basis, production costs were $23.29 per barrel in 2001 compared with $23.39 in 2000. The shut-in of the three wells in Trinidad accounted for the majority of the reduction in operating costs in 2001.

Netbacks

With high quality oil and low royalty rates, the 2001 average netback to the Company was approximately $15.06 per barrel. This is down 22% from the year 2000 primarily due to lower oil prices.

Interest Expense

Interest expenses fell by 45% to $9,527 in 2001 due to the conversion of $125,000 of convertible debentures into common stock.

Administrative Expenses

General and administrative expenses increased to $122,616 in 2001 from $107,704 in 2000. The higher costs are attributable to a full year of staffing the Kroes office and additional administration costs due to the Zhoda 2001 acquisition. Kroes continues to operate on a lean basis, as management receives no salaries.

Depletion and Depreciation

In 2001, depletion and depreciation fell to $15,503 from $30,646 in 2002. The decline in depletion is the result of the lower production in Trinidad. In 1998 the Company was required by generally accepted accounting principles to write down the carrying value of its Canadian oil and gas properties to virtually no cost. The small amount of depreciation recorded in 2001 is on office equipment.

Write Down of Cuban Assets

In 2001, the partners in Cuban offshore exploration blocks V, VI & VII relinquished their interest due to lack of success and prospectivity. As a result, the Company's $602,680 cost base for its 4.875% carried interest was written off.

Net Income and Cash Flow

The Company recorded a net loss of $477,921 in 2001 compared with a profit of $153,144 in 2000. The loss was attributable to the write down of the Cuban assets at a cost of $602,680.

Funds from operations was $158,404 in 2001 compared with $274,485 in 2000. Lower oil production and oil prices as well as higher administration costs resulted in the 42% decline in cash flow. On a per share basis, cash flow was $0.01 in 2001 versus $0.03 in 2000.

Capital Expenditures

The Company's investing activities increased by 150% to $383,267 in 2001. Essentially all funds were invested in engineering, audit and legal costs relating to the Zhoda 2001 acquisition, which conditionally closed in January 2002.

Liquidity and Capital Resources

The Company's capital investments in 2001 were primarily funded by cash flow and the proceeds from options that were exercised in 2001. At December 31, 2001 the Company had a cash balance of $138,536, which is sufficient to cover estimated administrative costs for the upcoming year.

The final closing of the Zhoda acquisition is expected to occur in the first half of 2002 on satisfaction of a number of conditions imposed by the TSX Exchange, the most significant of which is the completion of financing necessary to satisfy Zhoda's financing obligation. Zhoda must provide a USD$787,500 letter of credit to back a loan facility for Kashtan that can be drawn down to accelerate the redevelopment program in 2002. Kroes Energy Inc. has initiated a financing to achieve this requirement and has engaged Roche Securities Limited of Edmonton, Alberta as its Agent.

The financing is for a maximum of $1,750,000 and a minimum of $1,500,000 and involves the sale of a maximum of 7,000,000 and a minimum of 6,000,000 units at $0.25 per unit. Each unit comprises one common share and one common share purchase warrant. The warrant has a term of 18 months and can be exercised to purchase one common share at 50 cents. The financing is expected to be completed by the end of May 2002.

Business Risks

The business of exploring, developing, acquiring and producing oil and natural gas reserves is subject to a variety of operational, financial and regulatory risks.

Operational risks include finding and developing oil and natural gas reserves on an economic basis, reservoir production performance, marketing, production and accessing contract services on a cost-effective basis. Kroes follows the strategy of maximizing its assets by exploiting existing production and making use of advanced technologies to reduce risk and increase production.

Financial risks include commodity prices, interest rates and the Canadian/US dollar exchange rate, all of which are beyond the control of Kroes. Kroes has no debt and will fund its Canadian operations through cash flow while using equity to fund its Ukraine obligations.

Regulatory risks include environmental regulation, royalties and taxation, which are all beyond the control of the Company.

The Directors and Management of Kroes Energy Inc. pay particular attention to the political and economic progress in Ukraine and meet regularly with government officials to stay abreast of current policy developments.

Fred Callaway, *President*
May 17, 2002

PRICEWATERHOUSECOOPERS

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April 19, 2002

Auditors' Report

To the Shareholders of
Kroes Energy Inc.

We have audited the balance sheets of **Kroes Energy Inc.** as at December 31, 2001 and 2000 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

Calgary, Alberta, Canada

Kroes Energy Inc.

Balance Sheets

As at December 31, 2001 and 2000

	2001 $	2000 $
Assets		
Current assets		
Cash	138,536	144,274
Accounts receivable	127,872	163,673
Prepaid expenses and deposits	30,549	36,332
Inventory	785	771
	297,742	345,050
Future tax asset (notes 2 and 6)	373,700	373,700
Capital assets (note 3)	559,713	1,171,809
Deferred acquisition costs (note 10)	521,180	144,000
	1,752,335	2,034,559
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	133,489	25,934
Site restoration (note 9)	55,249	43,873
Convertible debentures (note 5)	24,530	142,764
	213,268	212,571
Shareholders' Equity		
Capital stock (note 4)		
Common shares issued	2,131,326	1,936,326
Equity portion of convertible debenture (note 5)	2,302	13,815
Deficit	(594,561)	(128,153)
	1,539,067	1,821,988
	1,752,335	2,034,559

Approved by the Board of Directors

_______________________ Director _______________________ Director

Kroes Energy Inc.

Statements of Operations and Deficit

For the years ended December 31, 2001 and 2000

	2001 $	2000 $
Revenue		
Oil and natural gas sales	734,193	878,498
Royalties	(39,018)	(39,724)
Interest and other income	3,032	3,784
	698,207	842,558
Expenses		
General and administrative	122,616	107,704
Operating	421,576	460,582
Interest expense on debenture	9,527	17,355
Depletion, depreciation and amortization	15,503	30,646
Future site restoration	11,376	11,390
Write down of Cuban assets	602,680	-
Foreign exchange gain	(7,150)	(12,963)
	1,176,128	614,714
(Loss) income before income taxes	(477,921)	227,844
Provision for future income tax (note 6)	-	74,700
Net (loss) income for the year	(477,921)	153,144
Deficit – Beginning of year	(128,153)	(729,697)
Conversion of convertible debenture	11,513	-
Effect of change in accounting policy (note 2)	-	448,400
Deficit – End of year	(594,561)	(128,153)
Basic net (loss) income per share	(0.043)	0.016
Diluted net (loss) income per share	(0.043)	0.014

Kroes Energy Inc.
Statements of Cash Flows
For the years ended December 31, 2001 and 2000

	2001 $	2000 $
Cash provided by (used in)		
Operating activities		
Net (loss) income for the year	(477,921)	153,144
Items not affecting cash		
Depreciation, depletion and amortization	15,503	30,646
Site restoration	11,376	11,390
Debenture interest amortization	6,766	4,605
Provision for future income tax	-	74,700
Write down of Cuban assets	602,680	-
Funds from operations	158,404	274,485
Net change in non-cash working capital items		
Accounts receivable	35,801	(60,382)
Prepaid	5,783	(6,532)
Inventory	(14)	18,345
Accounts payable and accrued liabilities	23,491	(13,506)
	65,061	(62,075)
	223,465	212,410
Financing activities		
Issue of common shares net of issuance costs	70,000	143,130
Investing activities		
Additions to capital assets	(6,087)	(14,245)
Deferred acquisition costs	(377,180)	(144,000)
Less: Accounts payable related to capital items	84,064	(72,608)
	(299,203)	(230,853)
Change in cash	(5,738)	124,687
Cash – Beginning of year	144,274	19,587
Cash – End of year	138,536	144,274
Supplemental information		
Interest paid	7,394	12,750
Debentures paid by issue of shares	125,000	-
Shares issued to pay debentures	125,000	-

The objectivity and integrity of data in these financial statements, including estimates and judgements relating to matters not concluded by year end, are the responsibility of management of the company. In management's opinion, the financial statements have been properly prepared within reasonable limits of materiality and within the framework of the company's accounting polices.

1 Significant accounting policies

Basis of presentation

These financial statements are prepared in accordance with Canadian generally accepted accounting principles using Canadian dollars.

Full cost method of accounting

The company follows the full cost method of accounting, whereby all costs relating to the exploration for, and the development of, oil and natural gas reserves are capitalized on a country-by-country cost centre basis. Costs accumulated within each cost centre are depleted and depreciated using the unit-of-production method, based on estimated gross proved reserves with production and reserves volumes of natural gas converted to equivalent energy units of crude oil. Proceeds from disposal of properties are normally deducted from the cost centre except when the disposition results in a significant change in the depletion rate in which case a gain or loss on disposal is recognized.

Costs of exploration in new cost centres, together with related land costs, are excluded from costs subject to depletion and the ceiling test until it is determined whether or not proved reserves are attributable to the properties, or if impairment has occurred.

In determining the depletion and depreciation provisions for oil and natural gas assets, the company includes any excess of the net book value of those oil and gas assets over the undiscounted future net operating revenues from its proved oil and natural gas reserves for each cost centre (ceiling test). A second ceiling test calculation is conducted on an enterprise basis, by including in the depletion and depreciation provisions any excess of the net book value of oil and natural gas assets less future taxes and the future dismantlement and site restoration costs for all cost centres over the unescalated, undiscounted future net revenues from proved oil and natural gas reserves, plus the cost of undeveloped properties, less future general and administrative expenses, financing costs and income taxes.

Other tangible assets are depreciated on a declining balance at a rate of 20% per annum.

Cash

Cash is comprised of cash balances and investments in term deposits with a duration of three months or less.

Inventory

Inventory is valued at the lower of cost and estimated net realizable value.

Future dismantlement and site restoration costs

Estimated future dismantlement and site restoration costs for oil and gas assets are provided using the unit-of-production method.

Joint ventures

Substantially all of Kroes' oil and gas exploration, development and production activities are conducted jointly with others. The financial statements reflect only Kroes' proportionate interest in such activities.

Foreign currency translation

- Monetary assets and liabilities – at the period-end rate of exchange
- Other assets and liabilities –at historical rates of exchange
- Revenues and expenses – at monthly rates of exchange except provisions for depletion and depreciation which are translated on the same basis as the related assets.

Unrealized gains and losses on translation to Canadian dollars of long-term monetary assets and liabilities are deferred and amortized over the remaining lives of the related assets and liabilities.

Income taxes

The company recognizes future income tax assets and liabilities for the estimated tax consequences attributable to differences between amounts reported in the financial statements and the tax bases of these amounts, using substantially enacted statutory tax rates. The effect of a change in substantially enacted statutory tax rates on future income tax assets and liabilities is recognized in the period that the change occurs.

Net income (loss) per share

The company has applied the treasury stock method to determine the dilutive effect of stock options and the if-converted method for convertible debentures. Under the treasury stock and if-converted methods, only "in the money" dilutive instruments impact the diluted calculations.

Income per share is calculated using the weighted average number of shares outstanding for the year. The weighted average number of common shares was 11,028,930 (2000 – 9,824,683). The dilutive per share calculations were based on additional incremental share of nil for a total of 11,028,930 (2000 – 1,500,000 and 11,324,683 shares respectively).

Stock-based compensation plan

The company has stock-based compensation plans. No compensation expense is recognized for these plans when stock options are issued to employees. Any consideration paid by employees on exercise of stock options or purchase is credited to share capital. A compensation expense is recorded when shares are issued to employees for no consideration.

Measurement uncertainty

The amounts recorded for depletion and depreciation of property, plant and equipment and the provision for site restoration costs are based on estimates. The ceiling test is based on estimates of proved reserves, production rates, natural gas prices, future costs and other relevant assumptions. The unproven property, plant and equipment costs recorded for operations in Trinidad are estimated by management to be fully recoverable. By their nature these estimates are subject to measurement uncertainty and the effect on the statements of cash flows in such estimates in future period could be significant.

2 Change in accounting policy

Effective January 1, 2000 the company adopted the liability method of accounting for the income taxes as recommended by the Canadian Institute of Chartered Accountants (CICA). Under the liability method, the company will record future income taxes for the effect of any difference between the accounting and income tax basis of an asset or liability. The company has retroactively adopted the CICA recommendations, without restating prior years, by recording a future tax asset of $448,400 and a decrease in deficit of $448,400.

In 2001, the company retroactively adopted in the CICA earnings per share standard. Under the new standard, the treasury stock method is used, under which proceeds from assumed exercise of in-the-money stock options are used to repurchase common shares at the prevailing average market price for the year. The adoption of this standard had no effect on diluted earnings per share for 2001 or 2000.

3 Capital assets

	2001 **$**	**2000** **$**
Office furniture and equipment	6,414	6,414
Intangible oil and gas properties	1,777,421	1,772,473
Tangible oil and gas equipment	119,852	118,834
	1,903,687	1,897,721
Accumulated depletion and depreciation	(1,343,974)	(725,912)
	559,713	1,171,809

Included in intangible oil and gas properties was the cost associated with Cuban assets of $602,680 which was the amount paid by Kroes to earn the carried interest. This asset has been written down to a nil value as the partners have relinquished the block.

Included in intangible oil and gas properties is the cost associated with the Trinidad assets of $572,155. Of this total, properties with a value of $364,228 are considered unproved properties and not subject to depletion. Depletion expense associated with the producing properties was $11,240 (2000 – $25,270).

4 Capital stock

The company's authorized capital stock is an unlimited number of common shares and an unlimited number of preferred shares issuable in series. No preferred shares have been issued.

Common shares issued

	Number	Amount $
Issued and outstanding – December 31, 1999	8,649,341	1,793,196
Private placement – March 2000	1,500,000	150,000
Issuance costs	-	(6,870)
Issued and outstanding – December 31, 2000	10,149,341	1,936,326
Debenture conversion – June 2001	1,250,000	125,000
Options exercised	350,000	70,000
Issued and outstanding – December 31, 2001	11,749,341	2,131,326

The following tables summarize information about the company's outstanding stock options:

	2001		2000	
	Number of options	Weighted-average exercise price $	Number of options	Weighted-average exercise price $
Outstanding – January 1	830,000	0.20	830,000	0.20
Granted	670,000	0.13	-	-
Exercised	(350,000)	0.20	-	-
Outstanding – December 31	1,150,000	0.16	-	0.20
Exercisable – December 31	1,150,000	0.16	830,000	0.20

	Outstanding options			Exercisable options	
Range of exercise prices ($/share) December 31, 2001	Number of options	Weighted-average exercise price ($/share)	Weighted-average years to expiry	Number of options	Weighted average exercise price ($/share)
0.20	480,000	0.20	0.5	480,000	0.20
0.13	670,000	0.13	2.9	670,000	0.13
	1,150,000	0.16		1,150,000	0.16

Options to purchase 480,000 common shares at $0.20 per share were granted to directors, officers and consultants of the company in 1998. The options expire February 19, 2003.

Options to purchase 670,000 common shares at $0.13 per share were granted to directors, officers and consultants of the company in 2001. The options expire November 14, 2006.

5 Convertible debentures

On July 1, 1999, Kroes issued 8.5% convertible debentures for proceeds of $100,000 with interest payable semi-annually beginning December 31, 1999. The term is three and half years, with the debenture due December 31, 2002. On each of August 5 and August 11, Kroes issued an additional $25,000 under the same terms.

The holders have the right to convert the principle amount, in whole or in part, into common shares of Kroes at a price of $0.10 per common share on or before July 1, 2001 or at $0.15 per common share after July 1, 2001, prior to forced conversion or redemption. Conversion must occur in multiples of $100.

Kroes has the right after January 1, 2000 to cause the holders to elect to convert the principal amount, in whole or in part, into common shares of Kroes provided the shares have traded over a 20 consecutive trading day period at a weighted-average price not less than 125% of the average of the conversion price in effect on each such day that the company's shares traded.

During the year, holders exercised their right to convert $125,000 of principal into 1,250,000 common shares valued at $125,000.

As these debentures are considered to be compound financial instruments, the liability component and the equity component must be presented separately, as determined at July 1, 1999. Kroes has valued the equity component of these debentures using the residual value of equity component method, whereby the liability component is valued first using the current market rate, for comparable instruments, at the time of issuance. The difference between the proceeds of the debentures issued and the fair value of the liability is assigned to the equity component. The resulting liability and equity values determined using this method based on a 12% interest rate are as follows:

	2001 $	2000 $
Proceeds of convertible debentures	25,000	150,000
Less: Fair value of equity component	(2,302)	(13,815)
	22,698	136,185
Plus: Amount amortized	1,832	6,579
	24,530	142,764

6 Income taxes

The provision for income taxes differs from the amount obtained by applying the combined Federal and Provincial income tax rates to income before income taxes. The difference relates to the following items:

	2001 $	2000 $
Income before income taxes	(477,921)	227,844
Corporate tax rate	42.6%	44.6%
Expected income tax expense (recovery)	(203,594)	101,618
Royalty add-back	-	40
Resource allowance	(16,175)	(26,359)
Non-taxable foreign exchange	(3,046)	(5,781)
Other	38,815	5,182
Future tax valuation allowance	184,000	-
Provision for future income tax	-	74,700

The future tax asset is comprised of temporary differences arising from the tax basis of assets being in excess of the net book value of capital assets by approximately $1,309,071 (2000 – $837,951). The company has reflected these differences by recording a future tax asset of $373,700 (2000 – $373,700) (see note 2), net of allowances of $184,000 relating to the future tax assets incurred in the current year but not considered more likely than not to be used.

7 Geographic segments

The company is organized into divisions by geographic area consisting of Canada, Cuba, Trinidad and Ukraine. All divisions derive revenue from oil and gas properties or are pursuing oil and gas production from properties.

					December 31, 2001
	Canada $	Cuba $	Trinidad $	Ukraine $	Total $
Net revenue	656,761	-	41,446	-	698,207
Net income (loss)	123,156	(602,680)	1,603	-	(477,921)
Identifiable assets	567,966	-	663,189	521,180	1,752,335

					December 31, 2000
	Canada $	Cuba $	Trinidad $	Ukraine $	Total $
Net revenue	730,880	-	111,678	-	842,558
Net income	135,396	-	17,748	-	153,144
Identifiable assets	652,898	602,680	634,981	144,000	2,034,559

8 Financial instruments

Fair values of financial assets and liabilities

The company's financial instruments recognized in the balance sheet consist of cash and short-term deposits, accounts receivable and accounts payable and accrued liabilities and convertible debentures. The fair values of the financial instruments recognized in the balance sheet approximate their carrying amounts due to the short-term maturity of these instruments.

Credit risk

The company is exposed to credit risk from financial instruments to the extent of non-performance by third parties. A substantial portion of the corporation's accounts receivable are with customers and joint venture partners in the petroleum and natural gas industry and are subject to normal credit risks.

Foreign exchange risk

The company has some operations in foreign countries which expose it to some foreign currency risk. Sales of products would generally be denominated in United States dollars.

9 Commitments and contingency

The company has estimated future site restoration liabilities of $86,481 of which $55,249 (2000 – $43,873) has been accrued and the balance will be accrued over the remaining production life of the Canadian assets.

10 Corporate item

The company entered into an agreement to acquire Zhoda 2001 Corporation, a Canadian private company that holds a 45% joint venture interest in the Lelyaki oil field rehabilitation project located in east central Ukraine for consideration of 8,600,000 common shares. To date, the company has capitalized acquisition costs of $521,180 related to engineering, audit, legal fees and other due diligence items. The final acquisition is subject to certain securities exchange and other conditions, the most significant of which is the completion of a financing for $1,000,000 to partially satisfy Zhoda's financing obligations which are U.S. $787,500.

Based on the December 31, 2001 financial statements of Zhoda 2001 Corporation, it is anticipated that the purchase equation to record the proposed acquisition, if completed, will be approximately as follows:

	$
Working capital	244,000
Capital assets	1,309,180
	1,553,180
Consideration	
Common shares at $0.12	1,032,000
Other costs of acquisition	521,180
	1,553,180

Operations will be recorded from the time of acquisition.

11 Subsequent event

The company has engaged an agent to obtain financing to a maximum of $1,750,000 and a minimum of $1,500,000 which involves the sale of units at $0.25 per unit. Each unit is comprised of one common share and one common share warrant. The warrant has a term of 18 months and can be exercised to purchase one common share at $0.50. The financing is expected to be completed in May 2002 and funds will be used in part to satisfy Zhoda's financing obligations (see note 10).

12 Comparative figures

Certain comparative amounts have been reclassified to conform to the current year's presentation.

Kroes Energy Inc.